SPECIAL REVIEW OF THE COMMONWEALTH OF VIRGINIA'S FIXED ASSET ACCOUNTING AND REPORTING SYSTEM

January 2003

APA
Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

EXECUTIVE SUMMARY

We have reviewed the Commonwealth of Virginia's Fixed Asset Accounting and Control System and the Commonwealth's internal controls and guidance over reporting capital assets to the Department of Accounts for inclusion in the Commonwealth's Comprehensive Annual Financial Report. We excluded infrastructure assets from this review. Overall, we have determined that state agencies and institutions are properly recording and reporting fixed assets, however there is need to improve the recording and reporting process and the relative guidance the Department of Accounts provides.

We have determined the Fixed Asset Section of the Commonwealth Accounting Policies and Procedures Manual does not provide agencies with the guidance necessary for them to properly record and report assets and their related depreciation. We determined that Accounts did program FAACS to properly calculate depreciation, maintain asset values, and accumulate ongoing depreciation balances. However, the accuracy of this information is dependent on the information that the individual users enter in the system, which is dependent on the users understanding the information they enter and how to use FAACS. We determined that there are several recordkeeping and policy issues that caused the Commonwealth to appear to have a large number of assets still in use with a zero value. These reasons include a lack of emphasis over the length of useful lives for depreciation, the use of improper useful lives, a lack of a policy requiring salvage values, improper recording of the disposal and surplus of assets, and a method to record additions and renovations that results in assets appearing to have a zero value but is necessary.

This report contains a series of recommendations on actions that the Department of Accounts can take to address the issues above. These actions should improve the use of the information available on general fixed assets and strengthen the agencies and institutions control over these assets.

- T A B L E O F C O N T E N T S -

Commonwealth of Virginia

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January 21, 2003

The Honorable Mark R. Warner
Governor of Virginia
State Capital
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The Honorable Kevin G. Miller
Chairman, Joint Legislative Audit
and Review Commission
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Richmond, Virginia

We have completed our review of the Commonwealth of Virginia's Fixed Asset Accounting and Control System and the Commonwealth's internal controls and guidance over reporting capital assets to the Department of Accounts for inclusion in the Commonwealth's Comprehensive Annual Financial Report.

Objectives

We had five objectives for our fixed asset review. These objectives were to:

1. Determine whether the Commonwealth's policies and procedures provide agencies with an understanding of the Fixed Asset Accounting and Control System (FAACS) and their responsibilities for using and maintaining the system.

2. Determine whether the Commonwealth's policies and procedures are adequate and updated to provide guidance necessary for agencies to properly record and report assets and their related depreciation.

3. Determine whether the Department of Accounts programmed FAACS to properly compute depreciation and accumulated depreciation for all capital assets in FAACS.

4. Determine whether state agencies properly use FAACS to account for their capital assets and depreciation in accordance with state capitalization policies.

5. Determine why the Commonwealth appears to have a large amount of assets still in use with a zero book value.

Scope

We reviewed the guidance provided by the Department of Accounts (Accounts) to agencies on the use of FAACS and the agencies' responsibilities over the system and the information they enter. We verified and tested that FAACS properly computes depreciation expense and accumulated depreciation. A preliminary analysis by Accounts showed the Commonwealth had a significant amount of assets with a zero value still in use in FAACS during fiscal year 2001 and we took a sample of these items to determine their status. We analyzed and considered possibilities for changing the capitalization threshold. We performed additional analysis at several agencies through an internal questionnaire.

We excluded infrastructure from this review. The Department of Transportation builds and maintains the majority of the Commonwealth's infrastructure assets in the form of highways, bridges, and tunnels. We reviewed the capitalization of these infrastructure assets during our fiscal year 2002 audit of Transportation. The results are included in our report issued January 15, 2003.

Results

We have determined the Fixed Asset Section of the Commonwealth Accounting Policies and Procedures (CAPP) Manual does not provide agencies with the guidance necessary for them to properly record and report assets and their related depreciation. The State Comptroller and the Accounts' staff have responsibility for proper presentation of fixed asset information in the Commonwealth's Comprehensive Annual Financial Report (CAFR) and ensuring the information is free from material misstatements. We found that Accounts needs to enhance the training for capital assets.

We determined that Accounts did program FAACS to properly calculate depreciation, maintain asset values, and accumulate ongoing depreciation balances. However, the accuracy of this information is dependent on the information that the individual users enter in the system, which is dependent on the users understanding the information they enter and how to use FAACS. We determined that there are several recordkeeping and policy issues that caused the Commonwealth to appear to have a large number of assets still in use with a zero value. These reasons include a lack of emphasis over the length of useful lives for depreciation, the use of improper useful lives, a lack of a policy requiring salvage values, improper recording of the disposal and surplus of assets, and a method to record additions and renovations that results in assets appearing to have a zero value but is justified. We analyzed the Commonwealth's assets and provided recommendations for Accounts to consider changing the capitalization threshold while maintaining the same level of control and stewardship over assets as in the past.

We discussed this report with the Department of Accounts on April 22, 2003.

AUDITOR OF PUBLIC ACCOUNTS

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General Conclusions

FAACS has the capabilities to provide the information necessary to properly report capital asset values, depreciation expense, and accumulated depreciation. However, the accuracy of this information is dependent on the accuracy of the information that the individual users enter in the system which is dependent on the users understanding the information they enter and how to use FAACS.

We found that Accounts needs to mandate new user training, enhance its current training, and update the Fixed Asset Section of the CAPP Manual.

FAACS includes a significant amount of assets still in use having a zero value. It appears that the user agencies either underestimated the useful lives of the asset, did not enter a salvage value, or simply recorded the information incorrectly. In addition, the method necessary to record additions and renovations for FAACS to properly calculate depreciation results in assets appearing to have a zero value.

Accounts should review its capitalization policies, which could reduce the recordkeeping for certain assets. Changing the capitalization policy could reduce both Accounts and the user agency data information requirements, and possibly allow user agencies to use other means to track equipment or other items under the dollar threshold.

The recordkeeping and policy issues we found did not affect our ability to give an unqualified opinion on the Commonwealth's Comprehensive Annual Financial Report (CAFR) for fiscal year 2002.

Background

The Fixed Asset Accounting and Control System (FAACS) is the Commonwealth of Virginia's official central fixed asset accounting system. In 1983, the Commonwealth established FAACS to record and track all of the Commonwealth's fixed assets. This initial system was paper driven and characterized by cumbersome forms, slow turnaround time due to manual data entry, and inflexibility due to a limited number of hard coded reports. The Department of Accounts (Accounts) addressed these issues through the development of a new web-based FAACS application to replace the older FAACS on-line data entry/inquiry system in Spring 2001. FAACS maintains information on fixed assets exceeding the capitalization threshold of $5,000. This information includes details such as the asset value, description, location, acquisition date, useful life, depreciation expense, accumulated depreciation, and additional details necessary for proper stewardship of the asset. FAACS provides agencies with depreciation and financial reporting capabilities and a tool to track assets, take inventories, and perform other stewardship functions. FAACS is not an asset management system. FAACS does not contain detailed information on the physical condition and preventive maintenance activities of the assets. As a result, many agencies maintain a separate asset management system to monitor the use and condition of assets.

Accounts exclusively developed and funded the FAACS system's web-based enhancement with internal resources. With the new enhancements to FAACS, agencies can now perform web-based data entry, which allows entry of new asset information, changes to information existing on the FAACS master file, and correction of errors. Data entered in FAACS on-line one day will result in asset additions or changes appearing on the master file the next day. Transactions that fail to pass system edits and any other asset transactions are available for review the following workday. Agency personnel may correct an error the same day it appears on the error file using the on-line features.

Accounts originally planned to implement a second phase for the new web-based FAACS, which would include ad hoc reporting capabilities. In June 2002, Accounts withdrew the second phase and replaced it with two other system changes: the first one creates a download feature for the FAACS master file data and the second revamps the Lease Accounting System (LAS). The download application will allow agency users to download all FAACS data into a spreadsheet or database, allowing agencies the ability to develop a wide range of reporting options. The system change to LAS will create a new web-based environment for leases, similar to FAACS. In the new environment, agencies will enter all of their own lease agreements rather than Accounts personnel entering the leases. Both system modifications will increase efficiency for agency users as well as Accounts.

There are two types of FAACS users, Central FAACS users and Non-central FAACS users (Summary Users - Higher Education and proprietary fund agencies). Central users are those agencies that provide detailed fixed asset transaction information to the centralized system maintained by Accounts. Non-central users are those agencies that maintain their own fixed asset information system and enter summary fixed asset information into FAACS. All agencies may use FAACS, but are not required to as long as they have an adequate system capable of meeting all financial reporting requirements.

As of June 30, 2002, the Commonwealth's total capital assets reported net of accumulated depreciation for Governmental Activities totaled $12.4 billion, Component Units totaled $5.2 billion, and Business Type Activities totaled $352 million. Our review covers only assets entered in FAACS by central users. These assets are part of the governmental activities. Of the $12.4 billion in net assets for governmental activities, $6.1 billion was VDOT's infrastructure, $4.2 billion was other VDOT assets, and $74 million were internal service fund assets. This review covered the remaining $2 billion of assets.

The Commonwealth's asset capitalization policy requires recording all assets that cost $5,000 or more and have an expected useful life of two years or more. Selected agencies and institutions of higher education use a capitalization limit lower than $5,000 for various reasons. The Commonwealth has four asset categories for FAACS. These categories include Land, Buildings, Infrastructure (formerly Improvements other than Buildings), and Equipment. Agencies must capitalize Construction in Progress (CIP) when project expenditures exceed the capitalization threshold. The Commonwealth requires capitalization of works of art and historical treasures except for collections that meet the following three criteria.

1. The collection is held for public exhibition, education, or research in furtherance of public service, rather than financial gain.

2. The collection is protected, kept unencumbered, cared for and preserved.

3. The collection is subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for the collection.

The Commonwealth uses the following ranges of estimated useful lives for its capital assets:

Buildings	1 - 75 years
Equipment	2 - 20 years
Infrastructure	5 - 50 years

Capital Asset Standards for Reporting

Although the Commonwealth has been reporting capital assets in its annual financial report in the past, the Governmental Accounting Standards Board's Statement No. 34, Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments placed increased emphasis on capital assets including related depreciation. This new standard placed a greater requirement on the government to re-examine and report long lived assets.

The new emphasis started with an expanded definition of capital assets that includes land improvements, easements, buildings, building improvements, vehicles, machinery, equipment, works of art, historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. Infrastructure assets are long-lived capital assets normally stationary in nature and usually preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets include roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems.

For the first time, governments would depreciate capital assets rather than only report gross amounts in a separate general fixed asset account group. Additionally, just like a business, governments would begin showing the cost of operations as depreciation expense on its operating statement.

All of these factors have changed the way the Commonwealth needs to record and track its capital assets and infrastructure. Below is our review of whether the Commonwealth's policies and procedures have incorporated these changes.

Training for Capital Asset Recordkeeping

Accounts provides basic FAACS training periodically throughout the year. This training typically familiarizes employees, who have assumed responsibilities for maintaining the agency's FAACS information, with the fundamental information, policies, procedures, controls and other operating information that a user would need to know. Accounts does not require attendance at the initial training before allowing someone to begin entering information into the system and does not provide any refresher courses for continuous users. Users can attend the basic training periodically for updates and attend only the policy portion of the class.

In preparation for the implementation of GASB Statement No. 34, Accounts provided training to agency fiscal officers and updated the Commonwealth's Accounting Policies and Procedures (CAPP) Manual in all areas. We reviewed these processes specifically for capital assets and the use of FAACS.

The training on GASB Statement No. 34 was not mandatory and many agency fiscal officers did not attend the training. In the year before implementation, Accounts held three training sessions in the summer of 2000 for agency fiscal officers. These training sessions provided background on GASB Statement No. 34, in general, and the changes that it would require. The sessions also provided guidance to agencies on how to complete Accounts' Attachments for the Financial Statement Directive to aid Accounts in gathering information to prepare proforma statements for the fiscal year before implementation. The training session discussed infrastructure, works of art, and historical treasures and the requirement to capitalize these items. These training sessions also discussed the review of asset values, depreciation, useful lives, and other information for the new disclosure requirements.

Accounts planned to hold four additional follow up training sessions in the summer of 2002. The sessions would provide guidance to agencies as they closed out their accounting records and completed Accounts' Attachments for the CAFR for the first time under GASB Statement No. 34. However, due to a lack of participant interest, Accounts only held two sessions.

Accounts' FAACS training class does not address the importance of the information entered into the system or address the effect that improper information has on financial reporting of capital assets. Without proper guidance and instruction, FAACS users may not have a clear understanding of their responsibilities over fixed assets and could cause a material misstatement of assets. Further, the classes are not mandatory for new system users.

<u>Recommendation #1:</u> Accounts should expand the FAACS user training class to include information on the importance of the detail information users enter in FAACS for each asset. The class should also provide insight on how the details relate to financial reporting of capital assets and the impact improper information has. Accounts should require that each FAACS user take this class before receiving access to the system. Accounts should also address user problems and provide updates on system changes during the FAACS class, through broadcast messages in FAACS, and e-mails to fiscal officers.

Commonwealth Accounting Policies and Procedures Manual

In addition to training, one of the keys to successfully using the FAACS system is having timely and accurate written instructions and user information. Accounts has provided this information in the Fixed Asset Section of the CAPP manual. Accounts has not updated this section of the CAPP manual for the changes caused by GASB Statement No. 34. We found the following:

- The Fixed Asset section continues to use pre-GASB 34 terminology, including references to the General Fixed Asset Account Group and financial statements no longer prepared.
- The Fixed Asset Section does not address the ability for users to record assets in a system or network rather than as individual assets.
- There is confusing guidance over how to handle renovations and additions to previously recorded assets. See the section "Zero Valued Assets" for additional discussion.
- The Fixed Asset Section does not reflect any changes to the processes resulting from the switch to the new web-based FAACS system. This includes outdated system controls, error messages, and available reports.

The FAACS users rely on the CAPP Manual for guidance in accounting and reporting for fixed assets. Inaccurate information and guidance could result in users improperly using FAACS and misstating asset and depreciation expense balances.

<u>Recommendation #2:</u> Accounts should update the Fixed Asset Section of the CAPP Manual to comply with GASB Statement No. 34 requirements, the new web-based FAACS system, and the other recommendations of this report.

Zero Valued Assets

During implementation of GASB Statement No. 34, a concern arose surrounding the volume of fully depreciated, or zero value, assets recorded in governmental entities' records. The second implementation guide for GASB Statement No. 34 states, "If the assets are significant, the estimated useful lives assigned to capital assets should be reconsidered. Assets still in use should not be reported as fully depreciated. At transition, the estimated useful life of an asset includes both the years the asset has been in service and the estimated number of years of service remaining."

In response to this concern, Accounts analyzed the assets in FAACS and determined that the Commonwealth had approximately $448 million in zero value assets during fiscal year 2001. Accounts consulted the Auditor of Public Accounts on this issue and how to resolve it. Accounts and the Auditor agreed that Accounts did not have to resolve the issue for the fiscal year 2002 CAFR and that this planned review would help identify the causes of the zero value assets and enable Accounts to implement actions to resolve the problems.

As of June 30, 2002, the Commonwealth had assets of approximately $460 million with a zero value in FAACS. These assets typically have a zero value because they have reached the end of their estimated useful life and the accumulated depreciation equals the asset's original value. However, in most cases the agencies recorded that they were continuing to use the asset.

As an objective of this review, we tried to determine why the Commonwealth appears to have so many zero valued assets still in use and propose recommendations to improve controls and policies for recording capital assets. During this process, we did not assess the condition or usefulness of the assets in question, since in most cases the agency reported the assets still in use. While we did find some issues with the recording of assets disposal or available for sale (surplus), the majority of the zero valuation result from agencies underestimating the useful life; not recording a salvage value; recording repairs, renovation, and other additions by a method necessary to properly calculate depreciation; and finally not performing a review for errors and other mistakes.

<u>Lack of Emphasis:</u>

In the past, accounting standards generally did not require the recording of depreciation for governments' financial reporting. As a result, accountants and auditors have not reviewed the establishment of useful lives and the resulting calculation of depreciation. The previous accounting focus was whether the asset's value was correct. The following statement in the CAPP Manual illustrates the previous emphasis "All assets, which require depreciation, must use the useful lives prescribed in this topic. Although all agencies may use depreciation as a management tool, it is primarily for the use of those agencies operating out of Enterprise or Internal Service Funds and/or whose operations contain federal funding."

In addition, because of this lack of emphasis, agencies did not periodically re-evaluate the useful lives of assets and change the lives based on that evaluation. During an asset's life, many events can occur that decrease or increase the originally expected useful life. Agencies should consider these events and adjust the useful lives and depreciation expense prospectively. However, for assets that have exceeded their useful life, the user should apply the change retroactively and show it as a change in accounting estimate to adjust the previous depreciation expense. However, Accounts did not program FAACS to automatically adjust depreciation from prior periods. If a user changes the useful life of an asset that has already reached its original useful life, there will be no affect on the past depreciation or accumulated depreciation amount without a manual adjustment by Accounts.

<u>Recommendation #3:</u> Accounts should specifically update the CAPP Manual to reflect the importance of useful lives, depreciation expense, and accumulated depreciation for all state agencies in compliance with GASB Statement No. 34. Accounts should require agencies to perform a periodic review and update of asset useful lives to ensure the estimated useful life closely mirrors the actual life of the asset.

<u>Use of Improper Useful Lives:</u>

The useful life is the expected length of time an asset should remain in working condition. FAACS uses a pre-determined nomenclature code for each asset that contains the asset description and the expected or planned useful life. The formulas in FAACS use the useful life, acquisition date, and salvage value to calculate depreciation. Each FAACS user selects a nomenclature code when entering an asset into FAACS using the asset description and useful life.

Accounts periodically updates the nomenclature codes and useful lives; however, agencies cannot create nomenclature codes. As a result, some assets only have one nomenclature code resulting in only one choice for a useful life. For example, there is only one nomenclature code with a useful life of five years for an airplane. Most airplanes, under normal maintenance circumstances, can last longer than five years.

Some assets have multiple nomenclature codes, providing more choices. For example, there are 29 nomenclature codes for buildings with useful lives ranging from 1 to 75 years. Due to limitations in FAACS, Accounts cannot separate the asset description and the useful life.

To compensate for this limitation, Accounts has put the responsibility on FAACS users to request additional nomenclature codes when an appropriate code is not already available. However, due to the lack of negative consequences of assigning an inappropriate useful life in the past, most users did not request the creation of useful lives, instead using what was readily available. We also found that many FAACS users were unaware that they could request a new nomenclature code even though the CAPP manual conveys this information. Additionally, many agencies do not have a methodology for assigning useful lives. Without proper or reasonable codes for users to select and agencies having no methodology, FAACS users often assign inappropriate useful lives to assets, resulting in assets not depreciating at an appropriate rate, creating a large number of zero value assets.

<u>Recommendation #4:</u> Accounts should require all agencies to develop and periodically update a methodology for assigning asset useful lives. By developing a methodology and applying it, agencies will select more appropriate useful lives and request additional nomenclature codes as necessary.

<u>Salvage Value:</u>

The salvage value of an asset is the estimated value it will have when it reaches the end of its useful life. Assets do not depreciate below their salvage value. Therefore, assets with a salvage value never fully depreciate while assets without a salvage value depreciate fully at the end of their estimated useful life. Currently, Accounts does not require that all assets have a salvage value. This is reasonable given the fact that not all assets have a salvage value at the end of their useful life. For example, due to continuing changes in technology, computers are often worthless at the time of replacement and, therefore, have no salvage value.

On the other hand, vehicles are often still in working order when replaced and can be sold for some value. However, because the salvage value field is not required in FAACS, many users do not even consider whether a salvage value is appropriate.

<u>Recommendation #5:</u> Accounts should consider requiring a salvage value for every asset entered in FAACS. An appropriate salvage value may be zero. However, by making the field required, Accounts will force users to consider the field and result in more assets having salvage values. This would lead to fewer assets ever reaching a zero value.

<u>Improper Surplus and Disposal Procedures:</u>

Some agencies do not properly surplus and dispose of assets in FAACS. The CAPP Manual distinguishes between the surplus and disposal process and the proper accounting for the assets in FAACS. Surplus assets are assets that are currently not in use. The physical location of a surplus asset governs its treatment in FAACS. When an agency is not currently using an asset but the asset remains on-site, the agency should classify the asset as "surplus." When an asset is no longer located on-site at the agency and is lost, stolen, discarded, or physically sent to the Department of General Services for other agencies to use or for sale, the agency should categorize the asset as "disposed."

Records for "surplus" assets remain in FAACS, and agency's ownership remains with the asset value, accumulated depreciation, and depreciation expense recorded in the agency's financial records and the CAFR. Records for "disposed" assets remain in FAACS for three years to provide an audit trail and the system automatically purges the record. However, once an agency disposes of an asset, financial records and the CAFR no longer show the asset value, accumulated depreciation, and depreciation expense.

Agency personnel often confuse the two processes. As a result, agencies have recorded assets they have disposed of as surplus and the assets remain on the agency's records. The majority of surplus assets are past their useful life, have a net value of zero, and consequently, have no material affect on the CAFR.

<u>Recommendation #6:</u> Accounts needs to re-emphasize the procedures governing the surplus and disposal of assets in FAACS to FAACS users through required training classes. Accounts should require the agencies to review FAACS and ensure that all surplus assets are properly recorded. Agencies should update FAACS to dispose of any surplus assets that they no longer physically possess.

<u>Additions, Renovations, and Repairs:</u>

Buildings, additions, renovations, and improvements make up a large portion of the Commonwealth's capital assets. Accounts' general policy states "all additions, renovations and repairs to fixed assets which increase the economic benefits of the assets should be added to the original cost of the assets. Routine repair costs incurred to maintain the asset in its operating condition are expensed and not included in FAACS." Maintenance costs allow an asset to continue to be used during its originally established useful life and should be expensed in the period incurred. Preservation costs that extend the useful life of an asset beyond its previously established useful life should be capitalized along with additions and improvements.

Accounts provides proper guidance on evaluating expenses on a case-by-case basis to determine the impact the expenses have on the asset. For expenses that materially extend the useful life, increase the capacity, or improve the efficiency of the underlying asset, users should add the expenses to the asset value and adjust the useful life accordingly. Users should expense repair and maintenance costs that maintain the asset in its operating condition or return it to its original condition after being damaged. However, due to limitations in the system, FAACS cannot properly calculate depreciation for an asset if the agency changes the cost of the asset but not the original acquisition date. FAACS calculates straight-line depreciation based on the original acquisition date, not the remaining useful life. To compensate for this system process, Accounts requires that users establish a separate asset in FAACS for each qualifying repair, renovation or improvement. By following this requirement, the user is not re-evaluating the original asset in FAACS. The original asset is staying on FAACS at its original value and useful life. The user is recording the renovation or addition as a separate asset. The original asset quickly depreciates while the new asset's useful life continues into the future. This requirement is confusing given guidance in the CAPP Manual to add costs to the original value. Since this process is necessary to properly calculate depreciation, the zero value assets caused by this situation are reasonable. However, Accounts should ensure that the new, separate assets could be easily associated with the original asset in FAACS.

Recommendation #7: Accounts needs to clarify its policy and guidance on how to handle additions, renovations, and improvements. Accounts should establish a method to associate the original asset and the newly established assets in FAACS and require agencies to enter the information necessary to accomplish this.

Capitalizing Assets below the Threshold:

The Commonwealth changed its capitalization policy in 1998, increasing the threshold from $2,000 to $5,000. Accounts policy allows agencies to control assets less than $5,000 on FAACS. We noted several agencies that did not either remove assets between $2,000 and $5,000 from FAACS or convert the assets from capital to controllable assets. At the end of fiscal year 2002, there were 16 agencies with over $20 million in capitalized assets under $5,000 that have reached the end of their useful life recorded in FAACS. Specifically, the Department of State Police and the Department of Mental Health, Mental Retardation and Substance Abuse Services have over $18 million of these assets.

Recommendation #8: Accounts should identify all agencies with capitalized assets below the current capitalization threshold of $5,000 on FAACS and require the agencies to change them to controllable.

Government's Use Differs from Private Sector:

Government entities often use assets for different purposes and for longer periods of time than the private sector does. Due to budgetary constraints, governments use assets for the longest life possible before replacing assets. There is little guidance on appropriate useful lives; however, what is available relates to private sector use. Accounts developed the current list of useful lives available in FAACS in conformity with the useful lives established by the Internal Revenue Service (IRS). However, the IRS established the useful lives to allow private companies to recover asset investments through tax deductions over a reasonable period. Tax considerations do not apply to state government. By relying on the IRS' guidance, the useful lives in

FAACS do not consider the asset use patterns in the government sector and assets reach their useful lives in the records before they do in real life.

<u>Recommendation #9:</u> When requiring agencies to develop a methodology for assigning asset useful lives, Accounts should encourage agencies to consider the different use patterns the Commonwealth has for assets. Agencies should take into account the actual length of time the agency has used different assets over time and set their methodology accordingly.

Material Agencies with Zero Valued Assets

We analyzed all assets with no book value in FAACS and identified the agencies below as having a majority of those assets. We obtained an understanding of each of these agencies' fixed asset internal controls through an internal questionnaire.

Agency	Original Asset Value for Assets with Zero Value
Department of Mental Health	$ 104,013,513
Virginia Port Authority	84,093,442
Department of State Police	46,533,662
Department of Corrections	42,982,928
Department of Transportation	32,349,336
Department of Education	16,615,182
Department of Game and Inland Fisheries	14,047,356
Department of Forestry	13,371,895
Department of Conservation & Recreation	13,139,784
Supreme Court	10,795,097
Department of Health	9,682,189
Total	387,624,384
Grand Total	$ 460,751,083

Questionnaire results disclosed internal weaknesses and potential issues as to why agencies have material amounts of assets that appear to have reached their useful lives in the accounting records but are still recorded as in use. These results support the conclusions discussed above. We noted the following issues from the 11 agencies surveyed:

- Five agencies did not have internal policies and procedures that supplemented the CAPP Manual regarding capital assets.

- Three agencies were using outdated CAPP manual or internal policies and procedures regarding capital assets.

- Two agencies did not have a full understanding of the CAPP Manual and FAACS data fields.

- Two agencies did not have an accurate understanding of the surplus and disposal procedures and related data fields in FAACS.

- Seven agencies did not have a methodology for determining useful lives of assets other than selecting the most appropriate nomenclature already established in FAACS.

- Four agencies use only required data fields in FAACS.

- Five agencies indicated they have not received proper asset management training and are interested in additional training.

- Three agencies have their own asset management system and double key assets into more than one asset system.

- Six agencies have an additional asset tracking system for information technology equipment.

Changes in Capitalization Threshold

Capitalization addresses financial reporting, not control, of assets. Threshold policies establish a unit cost to identify which capital assets to report in an entity's financial statements. A low capitalization threshold increases the number of items reported, while a high capitalization threshold decreases the number of items reported. Entities may establish different capitalization thresholds for different classes of assets. When establishing an appropriate capitalization threshold, the Government Finance Officers Association (GFOA) recommends setting the limit to capitalize approximately 80 percent of non-infrastructure assets. The Commonwealth's current threshold is $5,000. The Commonwealth uses this threshold for both asset control and financial reporting.

We researched other states to determine their asset capitalization thresholds as outlined below. As seen in the table, thresholds vary from state to state.

	Asset Categories		
State	Land	Buildings & Improvements	Equipment
Colorado	ALL	$5,000	$5,000
Georgia	ALL	$100,000	$5,000
Illinois	$100,000	$100,000	$5,000
Louisiana	ALL	$100,000	$5,000
Massachusetts	ALL	$100,000	$50,000
Michigan	ALL	$100,000	$5,000
Minnesota	ALL	$300,000	$30,000
New Hampshire	$100,000	$100,000	$10,000
North Carolina	$5,000	$5,000	$5,000
North Dakota	$5,000	$5,000	$5,000

State	Asset Categories: Land	Buildings & Improvements	Equipment
Oregon	$5,000	$5,000	$5,000
Pennsylvania	ALL	$25,000	$25,000
South Dakota	$5,000	$5,000	$5,000
Utah	$5,000	$5,000	$5,000
Washington	ALL	$100,000	$5,000

Note: All threshold amounts were taken from two different sources. The National Association of State Comptrollers, Survey on Capitalization and Related Matters, May – June 2002 and Internet Policies and Procedures for States that did not participate in this survey.

We stratified the Commonwealth's assets by category, excluding infrastructure, to determine the distribution of the asset values.

Capitalized Assets Recorded in FAACS
(Fiscal Year 2002)

	Land	Buildings	Improvements	Equipment	Total
Less than $5,000	$ 783,155	$ 1,455,527	$ 488,565	$ 31,222,607	$ 33,949,854
$5,000 - $24,999	4,305,733	32,803,461	7,860,008	221,713,646	266,682,848
$25,000 - $49,999	4,339,323	35,082,188	8,164,817	76,823,740	124,410,068
$50,000 - $99,999	8,045,814	76,385,734	13,581,404	47,606,433	145,619,385
Greater than $100,000 &	322,175,669	1,787,438,191	369,955,586	255,194,993	2,734,764,439
Total	$339,649,694	$1,933,165,101	$ 400,050,380	$ 632,561,419	$3,305,426,594
80 Percent	271,719,755	1,546,532,081	320,040,304	506,049,135	2,644,341,275

We reviewed the Commonwealth's capitalization level considering GFOA's recommendation. Based on this information, the Commonwealth could meet the 80 percent capitalization criteria for all assets by setting the threshold at $100,000 for all categories. Setting the threshold at this level will reduce assets reported in the CAFR by over $570 million.

Given the large quantity of assets owned by the Commonwealth and the substantial investment of resources in those assets, Accounts must recognize its responsibility to provide guidance to the agencies on how to control and manage assets under the capitalization threshold. Since many agencies already have asset management systems in addition to FAACS, we recommend that Accounts allow agencies to track and manage all assets under $100,000 either in FAACS or their own asset management system. However, Accounts should provide agencies with specific guidance and requirements for the control and maintenance of these assets. In changing the threshold, Accounts must ensure that agencies do not lose accountability for the assets.

Recommendation #10: *We recommend that Accounts change its capitalization threshold for capital assets for financial reporting purposes no higher than $100,000. Accounts should continue to require agencies to track and manage all assets above $5,000 either in FAACS or their own asset management system. Accounts should continue to provide agencies with specific guidance and requirements for the control and maintenance of these assets to ensure proper stewardship and accountability for these assets.*

APPENDIX A

COMMONWEALTH of VIRGINIA

DAVID A. VON MOLL, CPA
COMPTROLLER

Office of the Comptroller

P. O. BOX 1971
RICHMOND, VIRGINIA 23218-1971

May 9, 2003

Mr. Walter J. Kucharski
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

This letter provides the Department of Accounts' responses to the recommendations contained in your report on the review of the Commonwealth of Virginia's Fixed Asset Accounting and Control System (FAACS). Thank you for the opportunity to publish this letter with your report.

FAACS is the Commonwealth's Central Fixed Asset Accounting and Control System. It provides agencies with depreciation and financial reporting capabilities as well as with a means to track assets, take inventories and perform other stewardship related functions. It was intended to serve this dual purpose. Many agencies use FAACS primarily for the purpose of tracking their assets that are valued at or greater than $5,000. Some agencies track lower valued assets on FAACS as well. Some agencies use the depreciation information provided by FAACS, to provide documentation necessary for federal grant related reimbursements. Additionally, the Commonwealth's ability to recover indirect costs related to federal grants requires depreciation information on central service agencies. FAACS was implemented in 1983 and has served the Commonwealth well since that time.

DOA addressed many of the functional weaknesses associated with the original system through development of a new web-based FAACS application to replace the older FAACS on-line data entry/inquiry system in the spring of 2001. The new enhancements allow user agencies to perform web based data entry of new asset information, change information on the FAACS master file, and correct errors. DOA is continuing to create enhancements to the FAACS system. A web based master file downloading capability is planned for release by June 30, 2003. The download application will allow agency users to download all FAACS data into a spreadsheet or database; thereby, allowing agencies the ability to develop a wide range of monitoring and reporting options.

This response is intended to clarify issues, not criticize the report in any way. DOA has a great deal of appreciation for the cooperative working relationship we enjoy with the APA. Our comments address each of the recommendations individually.

1. **Training for Capital Asset Record Keeping**.

The quarterly FAACS training is designed to teach each individual exactly how to input the data into each of the fields of the FAACS screens. The individuals involved in this activity are generally not degreed accountants and do not possess a strong theoretical background in accounting. DOA does not believe that individuals with this background would benefit from a theoretical discussion of how incorrect information might effect the financial statements. The importance of inputting accurate data is currently stressed in FAACS training and will continue to be stressed in the future. The FAACS training as currently designed seems to be very effective, as evidenced by the fact that very few errors occur with inputting FAACS data. DOA does not believe that FAACS training should be mandatory. All agencies were required to send individuals to web based FAACS training when the system was put in place. The need for training new employees should be left to the discretion of the fiscal officers at the agencies. The agency fiscal officers should be able to familiarize a new employee with the FAACS input screens and decide whether additional training is necessary. DOA will continue to provide updates on system changes during FAACS class, through broadcast messages in FAACS, and via e-mails to fiscal officers.

2. Commonwealth Accounting Policies and Procedures Manual

DOA agrees with the recommendation and is in the process of updating the CAPP manual. FAACS is a reasonably simple and straightforward system. Although some of the FAACS topics need to be updated, the FAACS CAPP topics taken as a whole provide substantial guidance to the agencies to properly record and report assets and their related depreciation in FAACS to comply with GASB Statement 34. Several CAPP manual fixed asset sections have already been updated. All fixed asset sections of the manual will be updated by fiscal year end.

3. Zero Valued Assets

This issue arose pursuant to Question 145 of the 2nd GASB 34 Implementation Guide published in December 2001. DOA identified this issue in January 2002 shortly after the Implementation Guide was available. As a result, DOA performed the analysis that determined FAACS has a large amount of zero value assets. DOA brought this to the attention of the auditors more than a year ago and was prepared to take action to resolve the issue at that time. The APA requested that DOA do nothing to correct the problem until they were able to complete a review of FAACS statewide. The statewide FAACS report was received by DOA on April 2, 2003 and as previously stated the CAPP manual is in the process of being updated. The CAPP manual update will require agencies to perform a periodic review and update of asset useful lives. This is a very timely response to an issue that was not an issue prior to June 30, 2002. The review and update of an agency's FAACS records will be made much easier when the FAACS download project is fully developed and put into production.

4. Use of Improper Useful Lives

Many agencies have requested new nomenclature codes over the past few years. A number of new codes have been added to the nomenclature table. CAPP topic 30315, effective December 2001, directs agencies to notify DOA of nomenclature codes that are not available in the system and provides a form for the agencies to submit to request a new code. Agencies frequently call the FAACS staff when they are unable to find an appropriate code. There are currently over 1,700 nomenclature codes in FAACS. These codes were originally developed by a major accounting firm and were based on generally accepted practices at the time of implementation of FAACS. The codes have been adjusted and the number of codes has increased since the implementation of FAACS. DOA will require agencies to develop and periodically update a methodology for assigning asset useful lives and will re-emphasize the need to request new nomenclature codes when necessary.

5. Salvage Value

DOA agrees with this recommendation and will make salvage value a required input field.

6. Improper Surplus and Disposal Procedures

DOA has not experienced a problem with agency personnel confusing the surplus and disposal processes. The training suggested is currently emphasized in FAACS training and covered in the CAPP manual. Most agencies understand the distinction between surplus and disposal. DOA will reemphasize the procedures governing the surplus and disposal of assets in future training sessions. Additionally, the FAACS download project will enhance the agencies' ability to review and analyze surplus assets currently on FAACS.

7. Additions, Renovations, and Repairs

DOA is currently updating the CAPP manual and clarifying the policies related to additions, renovations, and improvements. FAACS currently has a method to associate the original asset with the newly established asset. Agencies will be required to use this methodology prospectively.

8. Capitalizing Assets Below the Threshold

DOA does not see a need to require currently capitalized assets that are below the current $5,000 capitalization threshold to be recorded as controllable. Some agencies such as DMHMR&SAS have a $1,500 capitalization threshold and are depreciating the asset in order to recoup federal funds. The capitalization policy for financial statement reporting purposes and the capitalization policy to meet agency needs may differ substantially.

9. Government's Use Differs from Private Sector

The APA has stated very clearly that there is very little useful life guidance beyond that established by the Internal Revenue Service (IRS). This is the guidance DOA is currently using and is considered the best available. DOA does not have the resources to develop different standards or guidance than those that the IRS developed. DOA will encourage agencies to consider different use patterns for assets. The agencies will be required to take into consideration the actual length of time the agency has used different assets over time and to set their useful life methodology accordingly.

10. Changes in Capitalization Threshold

DOA agrees that the capitalization threshold for financial reporting purposes should be increased. DOA performed the analysis and outlined new capitalization thresholds more than a year ago. DOA communicated this information to APA and APA requested that DOA do nothing until the statewide FAACS report was finished. Specific guidance for non-capitalized controlled assets and requirements for the maintenance of assets already exist in the CAPP manual. For financial reporting purposes, DOA will move to a $100,000 capitalization threshold for land, buildings and infrastructure, and a $50,000 threshold for equipment. DOA will continue to have agencies capitalize all fixed assets over $5,000 on FAACS or another acceptable system for control purposes.

I appreciate the APA's comments and recommendations. The FAACS systems audit and related recommendations provide valuable information to DOA that will be of assistance to ensure the Commonwealth continues to exercise strong stewardship over fixed assets and remains in compliance with GASB 34 . DOA plans to address all of the issues raised in the report.

Sincerely,

David A. Von Moll